

Board of Governors of the Federal Reserve System

**REPORT ON THE
AUDIT OF THE
BANK HOLDING COMPANY
INSPECTION PROGRAM**



OFFICE OF INSPECTOR GENERAL

(A9604)

August 1996

August 22, 1996

The Honorable Susan M. Phillips
Chairman
Committee on Supervision and Regulatory Affairs

We are pleased to present our final Report on the Audit of the Bank Holding Company Inspection Program (A9604). We performed our audit to evaluate the economy and efficiency of the bank holding company inspection process and to identify opportunities to reduce supervisory burden.

The bank holding company inspection program is undergoing a fundamental transformation as the Federal Reserve System implements a risk-focused approach to planning and conducting supervisory reviews. If successfully implemented, we believe the risk-focused approach articulated in recent Federal Reserve guidance could have a significant and positive impact on the economy and efficiency of the bank holding company inspection program and serve to reduce supervisory burden while maintaining safety and soundness standards as well as consistency across the Federal Reserve System.

While we endorse efforts to establish risk-focused bank holding company inspections, we also believe the Federal Reserve System faces many challenges as it moves toward the new approach. Our two recommendations to the Board and eight recommendations to the Director of Banking Supervision and Regulation are designed to help the Federal Reserve meet these challenges and enhance the economy and efficiency of the process by ensuring that sound policies, procedures, and practices are established for planning, conducting, and reporting the results of risk-focused Bank Holding Company BHC inspections.

Appendix 1 contains the Director of Banking Supervision and Regulation's response to the draft copy of this report. His response indicates general agreement with our ten recommendations and identifies a course of action to implement each of them.

We are sending a copy of this report to each member of the Board and to selected staff. Copies of this report are available to the public, and a summary will appear in our next semiannual report to the Congress.

Sincerely,

Brent L Bowen
Inspector General

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EXECUTIVE SUMMARY

Background

The Board of Governors of the Federal Reserve System (Board) has primary responsibility for supervising and regulating all bank holding companies (BHCs), their nonbank subsidiaries, and their foreign subsidiaries. In fulfilling this mission, the Board's Division of Banking Supervision and Regulation (BS&R) establishes and administers supervision policies and procedures, and the Federal Reserve Banks, acting under delegated authority from the Board, conduct periodic inspections of BHCs. Through its BHC inspection program, the Federal Reserve seeks to ensure that holding companies serve as a source of financial and managerial strength to their subsidiary banks and conduct their operations in a safe and sound manner. The frequency and scope of BHC inspections are determined by Board policy, which takes into account the holding company's asset size, complexity, and supervisory rating.

The Federal Reserve System is implementing a risk-focused approach to supervisory reviews as part of its effort to concentrate on areas that pose the greatest risks to financial institutions and to adopt supervisory processes that respond to these risks. The risk-focused approach changes the BHC inspection process by requiring a pre-inspection risk assessment that is used to align the scope of an inspection with the risks posed by an institution's size and activities. In addition, the new approach requires examiners to place more emphasis on evaluating BHC processes for identifying, measuring, monitoring, and controlling risks.

Audit Purpose

We performed our audit to evaluate the economy and efficiency of the BHC inspection process and to identify opportunities to reduce supervisory burden. We assessed the policies, procedures, and practices used to plan, conduct, and communicate the results of BHC inspections and reviewed the adequacy of examiner training and expertise. In addition, considerable attention was given to the System's planning and early implementation of the risk-focused approach to supervision.

Results

Overall, we found that the BHC inspection program is undergoing a fundamental transformation as the Federal Reserve System introduces a risk-focused approach to planning and conducting supervisory reviews. If successfully implemented, we believe the

risk-focused approach could have a significant and positive impact on the economy and efficiency of the BHC inspection program and serve to reduce supervisory burden while maintaining safety and soundness standards. Therefore, we endorse BS&R's efforts to establish risk-focused BHC inspections Systemwide and believe this initiative puts the System in a position to keep pace with the increasing sophistication of financial institutions' risk management systems and techniques. Nevertheless, the Federal Reserve faces many challenges as it moves towards the new approach. These include establishing sound policies, procedures, and practices for planning, conducting, and reporting the results of risk-focused BHC inspections along with hiring and retaining risk management and other experts.

The following recommendations, which are discussed in the body of the report, are designed (1) to help the Federal Reserve meet some of the challenges associated with introducing the risk-focused approach for BHC inspection, and (2) to enhance the economy and efficiency of the BHC inspection program. Specifically, we recommend that

- the Director of BS&R issue additional guidance to establish a consistent, Systemwide approach for conducting pre-inspection risk assessments;
- the Director of BS&R ensure that risk-focused supervisory reviews include procedures for reducing the scope of BHC inspections when work of a financial institution's internal auditors that is deemed timely and acceptable duplicates areas to be covered during an inspection;
- the Director of BS&R issue guidance regarding the content of first day letters;
- the Board revise its policy on the frequency and scope of BHC inspections to (a) reduce the frequency of inspections for certain noncomplex shell BHCs in satisfactory financial condition and (b) clarify the role of targeted inspections;
- the Director of BS&R develop a Work Documentation Program to assist Reserve Bank examiners in conducting and documenting BHC inspections;
- the Director of BS&R update and clarify the policy on management and service fees to ensure consistency throughout the Federal Reserve System;
- the Director of BS&R ensure that BHC inspection teams include examiners who have sufficient expertise in specialized products and technology;
- the Board establish separate examiner commissioning policies for experienced, specialized product and technology experts;

- the Director of BS&R revise the reporting requirements for bank holding company inspections to decrease the volume of information in inspection reports and shorten the time frame for issuing the reports to BHC management and directors; and
- the Director of BS&R establish a process to track the System's progress in implementing the risk-focused approach to supervision and disseminate information on lessons learned.

We make no recommendations on examiner training because we found that certain System committees responsible for the content of various courses have already identified the need for adjustments to reflect risk-focused concepts and procedures and are making modifications.

After completing fieldwork for this audit, we met with BS&R's senior management to (1) review our preliminary findings and recommendations and (2) get an update on activities related to improving the BHC inspection program. We were told that many of the issues contained in our recommendations had also been identified by various Systemwide task forces assigned to address issues ranging from strategic planning to improving supervisory processes. Accordingly, senior management commented that, in certain cases, our recommendations would be fulfilled by initiatives that were either planned or are in the early stages of implementation.

Analysis of Comments

We provided a draft copy of this report to the Director of BS&R for his review and comment. His response is included as appendix 1. The response indicates general agreement with each of our ten recommendations. Moreover, actions to implement the recommendations are either already underway or being planned.

